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Rising Rates Are Still Bullish For Equities

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis discusses interest rates and the stock market, and then provides some key economic charts that he uses to track the U.S. economy.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Rising rates are still bullish for equities**

You can also visit Scott Grannis' Home Page for his Blog at the link below: http://scottgrannis.blogspot.ca/

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Bob Weir, CFA: Director of Research

Wednesday, March 1, 2017

Rising Rates Are Still Bullish For Equities

There is obviously a lot going on these days, and most of it good, to judge by the market's recent behavior.

In mid-November I observed that a bond bear market is bullish for stocks. Since then, stocks have jumped over 10% and Treasury yields have risen 15-30 bps. Yesterday, the Fed strongly hinted that short-term rates are set to rise at the March FOMC meeting two weeks from now—which is earlier than the market had been expecting. The bond market now is priced to an 80% likelihood that the Fed soon will be paying banks 1% on banks' excess reserves, and that has pushed 3-month LIBOR (a proxy for short-term money market rates) to 1.09%. Interest rates are (finally!) *beginning* to become more normal, to the great relief of the nation's savers. (UPDATE: As of March 2nd, the odds of a March FOMC rate hike have risen to 90%.)

It is very likely that we are still in the early stages of more of the same. Interest rates are going to be rising, probably by more than the market currently expects, because the outlook for the economy is improving and inflation is at the high end of the Fed's target range, yet interest rates are still relatively low because of the market's willingness to pay up for safety—and that will not persist for much longer. Stocks are going to be buoyed by improving earnings and the prospect of stronger economic growth. Interest rates will be moving higher *because* of stronger growth—higher rates are not yet a threat to growth. The Fed is still a long way from raising rates by enough to threaten growth. If the FOMC hikes rates in two weeks it will not be a tightening, it will be a sensible reaction to stronger growth and improved confidence.

It is encouraging that the Fed has decided to pick up the pace of its interest rate "normalization." But I still worry that the Fed could fall behind the inflation curve, because short-term interest rates are still very low (well into negative territory) at a time when inflation is running at a solid 2%, the economy is showing clear signs of improvement, and confidence is rising. We are not in a stable equilibrium situation: in my view, interest rates need to move higher than the market currently expects. Otherwise, we will find ourselves in a situation where inflation is undesirably high and the Fed will be forced to forcibly tighten monetary conditions—which is exactly what has happened prior to every recession in recent memory. It bears repeating: to date, the Fed has kept monetary policy very accommodative in response to the market's persistent risk aversion and strong demand for money, and that is why Quantitative Easing has not resulted in an unwanted rise in inflation. But, now that confidence is returning and risk aversion is declining, the Fed needs to reverse course by shrinking its balance sheet and/or raising interest rates.

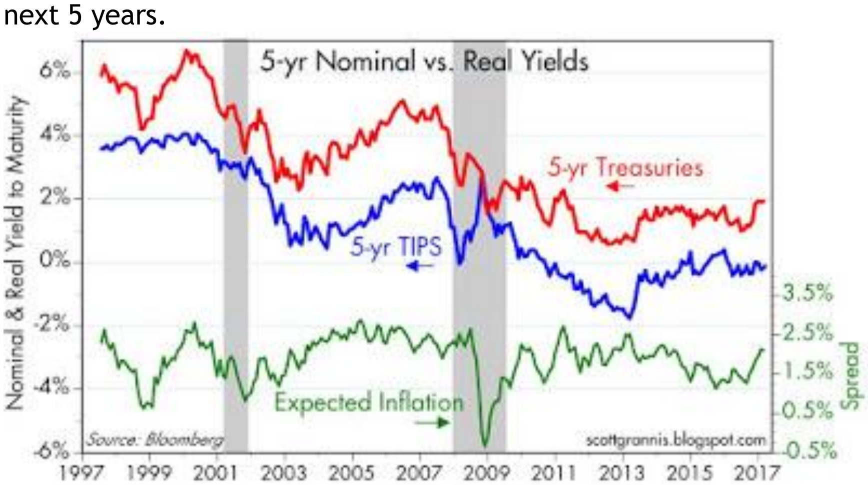
President Trump is still totally wrong on the subject of trade, but on almost everything else he is right. Last night's address to Congress was much more presidential than Trump's detractors feared, and the general thrust of his policy proposals is reassuring. He is a businessman who understands what makes the economy work, and he is thus very likely to reduce the headwinds that have held back the private sector for far too long (i.e., by reducing our onerous regulatory and tax burdens).

Now for a dozen or so charts and the stories they tell, in no particular order.

The chart below tells us that 5-yr Treasury yields, currently about 2%, are very low relative to core CPI inflation, which is running just over 2%. In a more normal environment, interest rates would be at least a percentage point higher than the prevailing level of inflation.

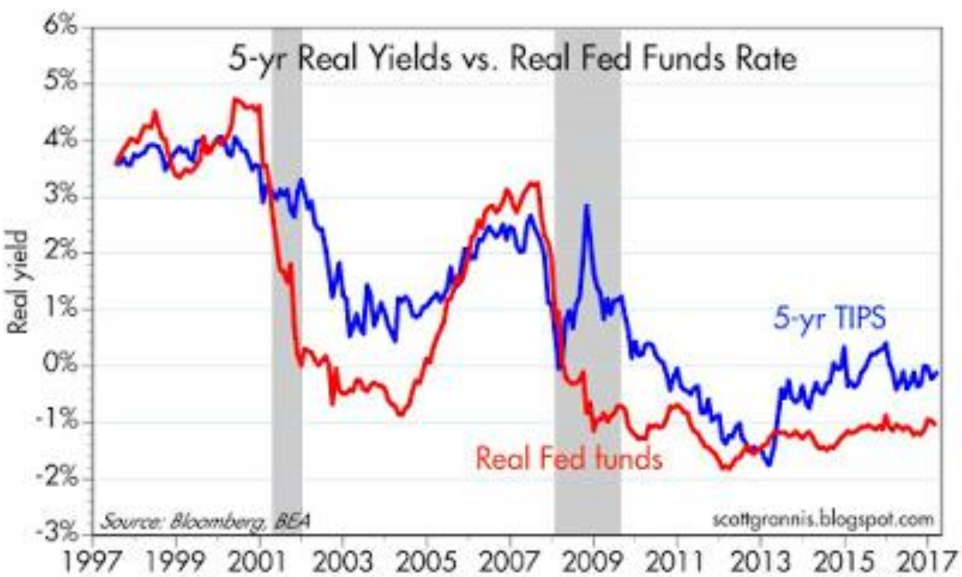
Many argue that the Fed is artificially depressing yields, but I don't agree. I think yields are abnormally low because the market's risk aversion is abnormally high; people are willing to pay a high price for the safety of Treasuries. In any event, I anticipate that yields will move significantly higher in the next year or so. The Fed has not done anything to bring inflation down (in fact, they seem to want it to remain at least 2%), but President Trump is likely to push through policies that boost the economy's growth rate and, in turn, boost confidence and reduce risk aversion. A stronger economy will make higher yields a necessity—a welcome necessity, I dare say.

The chart below shows the level of nominal and real 5-year Treasury yields, and the difference between them, which is the market's expectation for the average annual inflation rate over the next 5 years.



Inflation expectations have risen quite a bit over the past year, and are now firmly at 2%. If the economy picks up, as I expect it will, then both real and nominal interest rates ought to rise from current levels.

The chart below shows the current level of real overnight yields (red line), and the market's expected level of real overnight yields 5 years from now (blue line). The gap between the two is positive, and that means that the real yield curve is positively sloped and that, in turn, means that the market expects the Fed to raise the level real yields by almost one percentage point over the next 5 years. That is nothing to worry about. The time to worry is when the Fed pushes real short-term rates above the level of longer-term real rates (as it did prior to the past two recessions), since that is symptomatic of very tight money, and very tight money almost always results in a recession.



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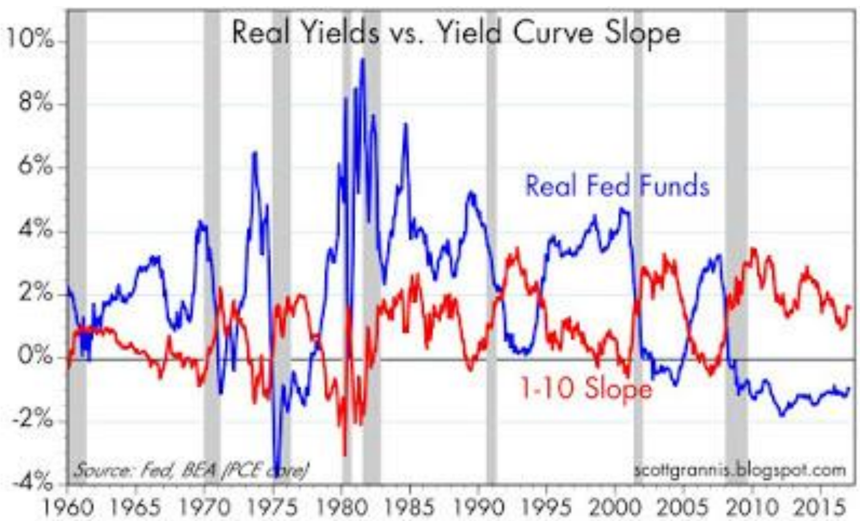
The next chart expands on that same theme. It shows that every time the Fed pushes real short-term rates up to 4% or more—thus making money very tight—the economy subsequently falls into recession. It also shows that every time the slope of the nominal yield curve (defined as the difference between 1-year and 10-year Treasury yields) becomes flat or negative, the economy subsequently falls into recession. In other words, when the Fed tightens aggressively, pushing real yields to strongly positive levels and the yield curve to very flat or inverted levels, it kills the economy by making money scarce and expensive. This is what we would like to avoid, but it might become necessary if inflation moves uncomfortably high. Fortunately, I doubt that is likely to happen within the next year or so. But beyond that we will just have to wait and see.



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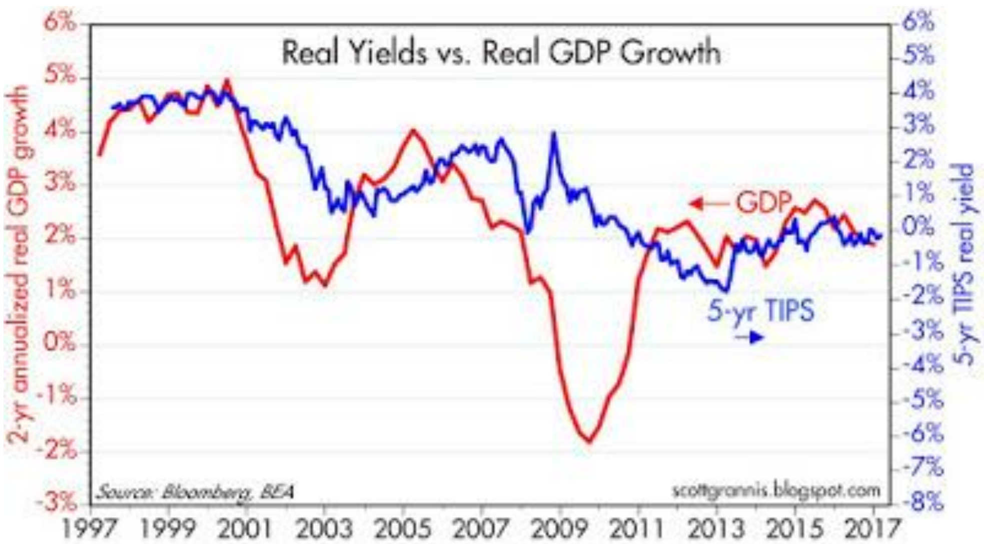
The next chart shows that there is a strong tendency for the level of real yields on 5-year TIPS to track the economy's underlying growth trend: the strong economic growth is, the higher real yields are, and vice versa. This is normal and understandable, since investors in TIPS receive a government-guaranteed real yield whereas investors in the real economy receive a real yield that is, on average, determined by the economy's real growth rate. Being risk-free, real TIPS yields ought to be somewhat lower than the market's expected real growth rate for the overall economy. Today, real TIPS yields are still slightly negative, and that suggests the bond market does not expect the economy to grow by much more than 2 or 2.5% per year. If stronger growth does happen, real yields will almost certainly rise significantly, as will their nominal counterparts.



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The chart below shows the rate of inflation according to the Personal Consumption Deflator. For the year ended last January, the overall PCE deflator rose 1.9%, while the core version rose 1.7%. Both measures are likely to move higher in the months to come, to judge by their behavior over the past several months. Deflation is officially a thing of the past, and there is no reason for the Fed to continue to be aggressively accommodative. Raising rates by even as much as one full percentage point would not constitute "tight" money, since real rates would still be relatively low.

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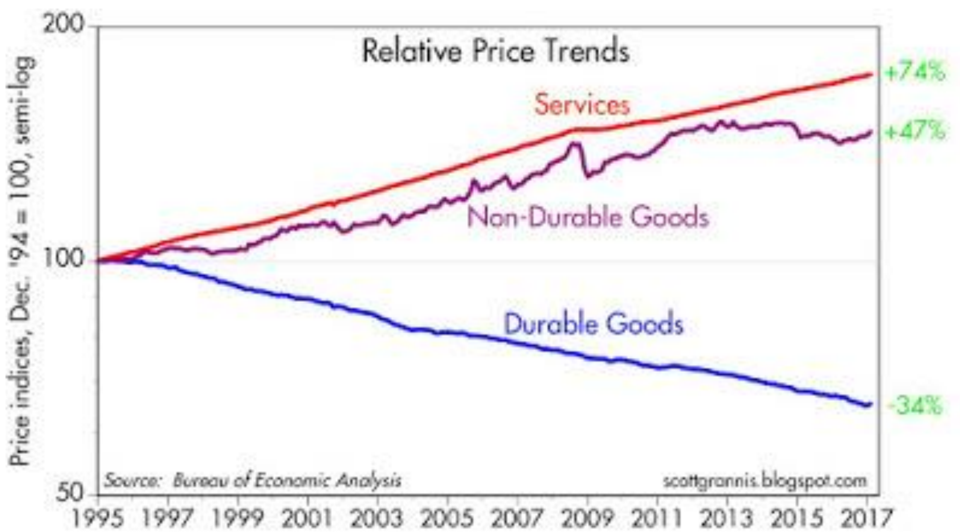
The next chart breaks down the PCE deflator into its main constituent parts. Here we see the huge divergence between the prices of durable goods, which have fallen by more than one-third over the past two decades, and the prices of services (mainly labor), which have risen by more than two-thirds over the same period. It is not a coincidence that durable goods prices started falling (for the first time ever, on a sustained basis) right around the time that China became a major exporter of durable goods in 1995. Thanks in large part to China's emergence as a manufacturing powerhouse, U.S. consumers have seen their purchasing power soar to unimaginable heights: an hour's worth of work today buys 2.6 times as much in the way of durable goods as it did in 1995 (1.74/.66). No wonder everyone has a smartphone.



Trump is crazy to want to stop this. Taxing imports would only result in higher prices for all consumers.

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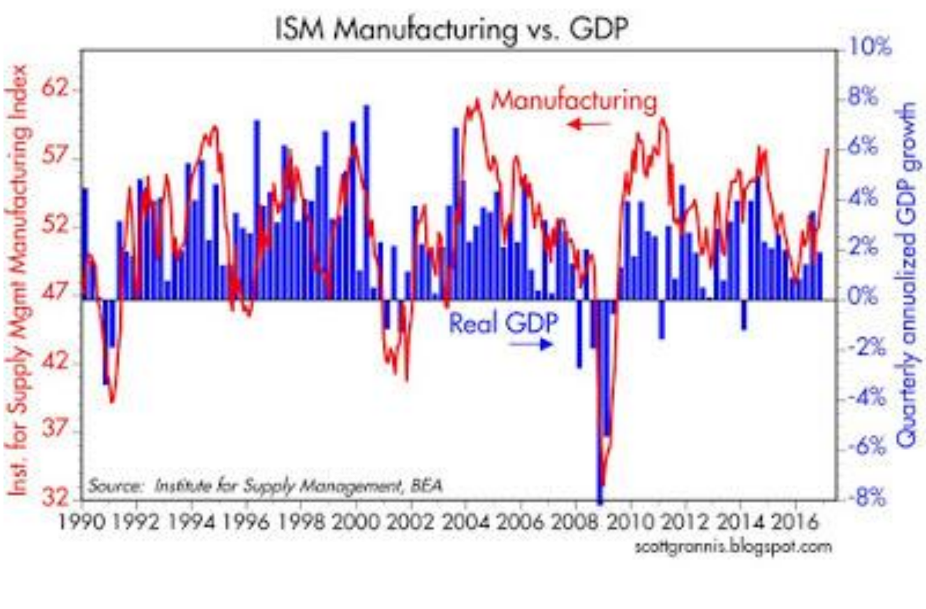
The latest consumer confidence survey by the Conference Board shows that optimism is returning in a big way. This is also seen in a big rise in the Small Business Optimism index, which is now almost as high as it has been in the past 40 years. Rising confidence should go hand in hand with a decline in the demand for money which, until recently, has been exceptionally strong. As money demand declines, the Fed must take countervailing steps to reduce the supply of money and/or raise interest rates in order to boost the demand for money. Otherwise higher inflation will result.

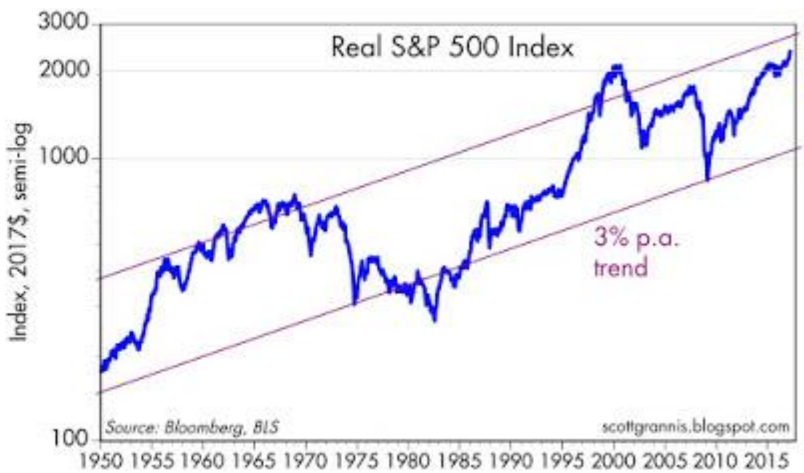
Today's ISM manufacturing survey was stronger than expected. As the chart below suggests, this points strongly to a pickup in overall economic growth in the months to come.



It is very encouraging to see that the same survey in the Eurozone also shows improvement, as seen in the next chart. A coordinated pickup in activity both here and overseas can really change the mood of the markets, and I think that is one reason global equity markets have been moving higher of late.

The chart above is one I've been showing for years. With fear subsiding and confidence in the economy rising, it is no wonder that stocks are moving higher.

The two charts above show the S&P 500 index in both nominal and real terms, together with my estimate of their long-run trend channels.



I don't want to suggest we are due for a decline, but I do think it is worth noting that this is not the time to take outsized risks. I would be a lot more worried about a market correction if bond yields (both real and nominal) were not so low, since today's low yields are symptomatic of an enduring and pervasive degree of risk aversion. The market is most vulnerable when everyone is optimistic.

BW: See ABOUT THE AUTHOR on the next page.

ABOUT THE AUTHOR

Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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